

**DEPARTMENT OF STATE REVENUE  
LETTER OF FINDINGS: 02-0515  
Individual Adjusted Gross Income Tax  
For the 1996 Tax Year**

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**ISSUE**

**I. Claim-of-Right Deduction – Indiana Adjusted Gross Income Tax.**

**Authority:** Ind. Const. art. 10, § 8; IC 6-3-1-3.5; I.R.C. § 62; I.R.C. § 1341; Reference Copies of Federal Tax Forms and Instructions (1996).

Taxpayer argues that the Department erred when it disallowed a deduction taken on his 1996 Indiana income tax return. The deduction consisted of an amount of money which taxpayer paid as restitution.

**STATEMENT OF FACTS**

Taxpayer embezzled sums of money from his former employer over a period of years prior to 1996. Taxpayer's theft of funds was detected, and taxpayer repaid the amount in July of 1996. Afterwards, taxpayer submitted amended state and federal tax returns in September of 1996 reflecting the amounts of money which had been embezzled during those years. To pay the additional taxes incurred as a result of the amended returns, taxpayer entered into an extended payment plan with the state.

Thereafter, taxpayer submitted his 1996 Indiana tax return. On that 1996 return, taxpayer claimed a deduction of approximately \$240,000 representing the amount taxpayer repaid to the former employer. The amount deducted was listed on Indiana schedule one, line 18 as "repayment of income without claim of right." The Department disallowed the deduction and assessed an additional amount of taxes.

Taxpayer challenged the disallowance, an administrative hearing was held, and this Letter of Findings follows.

**DISCUSSION**

**I. Claim-of-Right Deduction – Indiana Adjusted Gross Income Tax.**

Having been granted a claim-of-right deduction on his 1996 federal return, taxpayer argues that he is entitled to a similar deduction on his corresponding state return.

Taxpayer's deduction on his federal return was apparently based on I.R.C. § 1341. The federal rule provides in part:

If (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;

(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item.

The Department does not challenge taxpayer's assertion that, in calculating his federal income tax, he was entitled to claim the repayment amount as a specific income adjustment under I.R.C. § 1341. Taxpayer – in filing his amended federal returns – reported the amounts embezzled during the years in which those amounts were received. Thereafter, on his 1996 federal return, taxpayer was entitled under I.R.C. 1341 to claim the amount repaid as a deduction because taxpayer did not have “an unrestricted right” to the embezzled funds.

Indiana levies an income tax under authority of Ind. Const. art. 10, § 8 which states that, “The general assembly may levy and collect a tax upon income from whatever source derived, at such rates, in such manner, *and with such exemptions as may be prescribed by law.*” (*Emphasis added*).

In levying that tax, Indiana has largely adopted the federal definition of adjusted gross income. “When used in IC 6-3, the term ‘adjusted gross income’ shall mean the following: (1) In the case of all individuals, ‘adjusted gross income’ (as defined in Section 62 of the Internal Revenue Code) . . . .” IC 6-3-1-3.5.

Thereafter, the Indiana statute lists a number of specific modifications to the federal adjusted gross income amount. None of the specific modifications – peculiar to the Indiana tax scheme – are relevant to taxpayer's claim that he is entitled to deduct the amount paid in restitution during 1996.

Because Indiana's definition of “adjusted gross income” borrows from the federal definition, a citation to the federal authority is helpful. In part, I.R.C. § 62 states that, “For purposes of this subtitle, the term ‘adjusted gross income’ means, in the case of an individual, gross income minus the following deductions . . . .” Again, the subsequent federal provisions are irrelevant to taxpayer's argument.

The federal rules permit a taxpayer to claim a repayment of money included as income in an earlier year. The repayment amount is reported on line 27 of “Schedule A” which allows a “Deduction for repayment of amounts under a claim of right if over \$3,000.” Reference Copies of Federal Tax Forms and Instructions, p. 98 (1996). The total amount of “Itemized deductions from Schedule A” is then subtracted from the amount of federal adjusted gross income yielding federal “taxable income.” What all of this means is that the “claim-of-right” adjustment is a

“below the line” deduction computed after the taxpayer calculates the amount of federal adjusted gross income.

Taxpayer was entitled to the repayment deduction in determining his federal “taxable income,” but that particular amount is immaterial in calculating the taxpayer’s Indiana income tax. Under IC 6-3-1-3.5, federal adjusted gross income as defined in I.R.C. § 62 is the starting point for determining Indiana taxable income. The Indiana income tax act contains no provision authorizing the I.R.C. § 1341 “below the line” adjustment claimed on taxpayer’s 1996 federal return. The “claim-of-right” adjustment is not used to arrive at federal adjusted gross income which – subject to specified adjustments – becomes Indiana taxable income.

Taxpayer argues that he is entitled to the deduction “[l]ogically and under a sense of fairness.” The result may appear inequitable, but the Department has no authority to grant taxpayer’s request.

### **FINDING**

Taxpayer’s protest is respectfully denied.

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